

Consolidated Financial Statements with Supplemental Information and RUS Letters



## Consolidated Financial Statements with Supplemental Information and RUS Letters

Years Ended December 31, 2012 and 2011

#### **Table of Contents**

	Page
Independent Auditors' Report	1
Financial Statements:	
Consolidated Balance Sheets	3
Consolidated Statements of Operations	5
Consolidated Statements of Changes in Stockholder's Equity	6
Consolidated Statements of Cash Flows	7
Notes to Consolidated Financial Statements	9
Supplemental Information:	
Consolidating Balance Sheets	17
Consolidating Statements of Operations	19
Consolidating Statements of Cash Flows	20
Independent Auditors' Management Letter	22
Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards	26

Personal Local Global

#### INDEPENDENT AUDITORS' REPORT

To the Board of Directors Rural Telephone Company and Subsidiaries Glenns Ferry, Idaho

We have audited the accompanying consolidated financial statements of Rural Telephone Company and Subsidiaries, which comprise the consolidated balance sheet as of December 31, 2012, and the related consolidated statements of operations, changes in stockholder's equity, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

#### MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

#### **AUDITOR'S RESPONSIBILITY**

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### **OPINION**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Rural Telephone Company and Subsidiaries, at December 31, 2012 and the results of its operations and cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

#### REPORT ON CONSOLIDATING INFORMATION

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information in the accompanying schedules is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

#### OTHER REPORTING REQUIRED BY GOVERNMENT AUDITING STANDARDS

In accordance with *Government Auditing Standards*, we have also issued a report dated 5/8/2013, on our consideration of Rural Telephone Company and Subsidiaries' internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Rural Telephone Company's internal control over financial reporting and compliance.

#### **OTHER MATTERS**

The financial statements of Rural Telephone Company and Subsidiaries, as of December 31, 2011, were audited by other auditors whose report dated April 26, 2012 expressed an unmodified opinion on those statements.

 $\mathcal{A}KT\mathcal{L}\mathcal{L}P$ 

5/8/2013 Salem, Oregon

#### **Consolidated Balance Sheets**

December 31, 2012 and 2011

ASSETS	2012		2011
Current Assets:			
Cash and cash equivalents \$	1,105,978	\$	684,724
Marketable securities	12,119		45,897
Accounts receivable, net of allowance for doubtful accounts of zero	330,875		305,356
Other accounts receivable, net of allowance for			
doubtful accounts of \$90,000 in 2012 and 2011	909,930		983,222
Materials and supplies	929,246		797,177
Prepaid expenses	22,902	-	23,010
Total Current Assets	2 211 050		2 020 206
Total Cullent Assets	3,311,050	-	2,839,386
Other Assets:			
Related party receivables	529,176		521,495
Other assets	13,563		17,913
Investments	2,044,898		1,926,566
Marketable securities	22,674		47,317
Total Other Assets	2,610,311	-	2,513,291
Property, Plant, and Equipment:			
Telecommunications	52,149,538		50,143,388
Under construction and held for future use	811,089		1,413,935
	52,960,627	•	51,557,323
Less accumulated depreciation	37,783,787		35,822,622
·		-	
Telecommunications, net	15,176,840		15,734,701
Non-regulated, net	33,535		32,557
Acquisition adjustment, net	1,462,218		1,740,046
		•	
Property, plant, and equipment, net	16,672,593	-	17,507,304
\$	22,593,954	\$	22,859,981

LIABILITIES AND STOCKHOLDER'S EQUITY	2012	2011
Current Liabilities:		
Current portion of long-term debt \$	1,456,624	\$ 1,768,280
Accounts payable	1,234,210	431,051
Customer deposits	12,171	133,417
Accrued expenses	408,305	343,890
Total Current Liabilities	3,111,310	2,676,638
Long-Term Debt	9,934,453	10,872,766
Stockholder's Equity:		
Common stock, 2,500 shares authorized, \$100 par value, 569 shares issued and outstanding	56,900	56,900
Paid-in capital	10,197	10,197
Retained earnings	9,481,094	9,243,480
Total Stockholder's Equity	9,548,191	9,310,577
\$	22,593,954	\$ 22,859,981

## **Consolidated Statements of Operations**

	_	2012	_	2011
Operating Revenues:				
Local network	\$	1,337,915	\$	1,398,266
Network access		7,602,566		7,921,988
Toll services		84,610		87,153
Internet services		1,706,440		1,309,991
Cable television services		130,995		124,783
Miscellaneous	_	206,150	-	116,696
Total Operating Revenues	_	11,068,676	-	10,958,877
Operating Expenses:				
Plant specific		2,547,992		2,579,349
Plant nonspecific		735,328		714,996
Customer		572,031		602,789
Corporate		2,490,067		2,490,074
Depreciation and amortization		2,238,990		2,280,612
Cost of toll services		48,425		46,685
Cost of internet services		1,332,793		1,047,050
Cost of cable television services		201,181		228,038
Other operating taxes	_	293,353	-	349,124
Total Operating Expenses	_	10,460,160	-	10,338,717
Operating Income	_	608,516	-	620,160
Other Income:				
Investment income, net		233,998		372,195
Other income and expense, net		30,800		101,994
Other nonregulated operations, net	_	114,228	-	58,160
Total Other Income	_	379,026	-	532,349
Income Available for Fixed Charges		987,542		1,152,509
Fixed Charges - interest on long-term debt	_	659,781	-	708,736
Net Income	\$	327,761	\$	443,773

## Consolidated Statements of Changes in Stockholders' Equity

		Common Stock	Paid-In <u>Capital</u>	Retained <u>Earnings</u>	<u>Total</u>
Balance, December 31, 2010	\$	56,900	10,197	8,853,596	8,920,693
Net income		-	-	443,773	443,773
Distributions	_			(53,889)	(53,889)
Balance, December 31, 2011		56,900	10,197	9,243,480	9,310,577
Net income		-	-	327,761	327,761
Distributions	_			(90,147)	(90,147)
Balance, December 31, 2012	\$_	56,900	10,197	9,481,094	9,548,191

## **Consolidated Statements of Cash Flows**

		2012		2011
Cash Flows from Operating Activities:		_		_
Net income	\$	327,761	\$	443,773
Adjustments to reconcile net income to net cash				
provided by operating activities:				
Depreciation and amortization		2,238,990		2,280,612
Unrealized loss on marketable securities		35,198		2,795
Noncash patronage		(5,400)		(31,022)
Income from equity method investments		(218,745)		(230,737)
Allowance for funds used during construction		(29,593)		(37,093)
Changes in assets and liabilities:				
Accounts receivable		41,317		7,904
Materials and supplies		(132,068)		63,887
Prepaid expenses		108		9,110
Accounts payable		844,309		(245,770)
Customer deposits		(797)		(4,194)
Accrued expenses		(93,412)		(31,421)
Related party receivables and payables, net	_	(5,563)	_	
Net Cash Provided by Operating Activities		3,002,105	_	2,227,844
Cash Flows from Investing Activities:				
Capital expenditures, net		(1,584,030)		(1,818,198)
Purchase of investments and marketable securities		(22,832)		(30,112)
Proceeds from investments and sales of marketable securities		151,867		31,874
Change in other assets		4,349		(17,205)
Proceeds from note receivable	_	567	_	
Net Cash Used by Investing Activities	\$_	(1,450,079)	\$_	(1,833,641)

## **Consolidated Statements of Cash Flows, continued**

	_	2012	_	2011
Cash Flows from Financing Activities:				
Payments on long-term debt	\$	(1,644,029)	\$	(2,107,761)
Proceeds from long-term debt		394,060		1,351,731
Proceeds from ARRA BIP grant		209,344		-
Distributions to stockholders	_	(90,147)	_	(53,889)
Net Cash Used by Financing Activities	_	(1,130,772)	_	(809,919)
Net Change in Cash and Cash Equivalents	_	421,254	-	(415,716)
Cash and Cash Equivalents, beginning	_	684,724	_	1,100,440
Cash and Cash Equivalents, ending	\$_	1,105,978	\$	684,724
Cash Paid During the Year for Interest, Net of Amount Capitalized	\$_	656,324	\$ <u>_</u>	671,643

#### **Notes to Consolidated Financial Statements**

Years Ended December 31, 2012 and 2011

#### **Note 1 - Summary of Significant Accounting Policies**

#### Organization

Rural Telephone Company (the Company) is an Idaho S Corporation providing telecommunications services in Idaho and Nevada. Pend Oreille Telephone Company (POTC) is a wholly-owned Washington S Corporation providing telecommunications services in Washington. Nehalem Telecommunications, Inc. (NTI) is a wholly-owned Oregon S Corporation providing telecommunications services in Oregon. The Company is a wholly-owned subsidiary of Martell Enterprises, Inc. (an S Corporation).

#### Basis of Consolidation

The consolidated financial statements include the accounts of Rural Telephone Company and its Subsidiaries. All intercompany transactions and balances have been eliminated in the consolidation.

#### Regulation

The Company is subject to limited regulation by the Idaho Public Utility Commission (IPUC), Public Utility Commission of Nevada, and the Federal Communications Commission (FCC). Its subsidiaries are subject to limited regulation by the Washington Utilities and Transportation Commission (WUTC) and the Oregon Public Utility Commission. The Company maintains its accounting records in accordance with the Uniform System of Accounts, as prescribed by the Federal Communications Commission (FCC). As a result, the application of accounting principles generally accepted in the United States of America by the Company differs in certain respects from the application by non-regulated entities. Such differences primarily concern the time at which certain items enter into the determination of net income.

Regulatory and legislative actions, as well as future regulations, could have a significant impact on the Company's future operations and financial condition. See Note 1, National Broadband Plan and FCC Order.

#### **Estimates**

The Company uses estimates and assumptions in preparing financial statements in accordance with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses.

#### Cash and Cash Equivalents

The Company considers all highly liquid investment securities purchased with a maturity of 3 months or less to be cash equivalents. The Company maintains its cash either in bank deposit accounts that are insured by the Federal Deposit Insurance Corporation (FDIC) up to a limit of \$250,000 per depositor, or in certain non-interest bearing accounts that are fully insured by the FDIC. As of December 31, 2012 and 2011, the Company had no uninsured cash.

Subsequent to year end the temporary liquidity guarantee program, which fully insured all non-interest bearing accounts, expired. Therefore, at January 1, 2013, the Company had approximately \$91,000 of uninsured cash.

The Company has not experienced any losses on such accounts and believes it is not exposed to any significant credit risk on cash.

#### Fair Value of Financial Instruments

The Company's financial instruments, none of which are held for trading purposes, include cash and cash equivalents, receivables, marketable securities, accounts payable, and long-term debt. The Company estimates that the fair value of all of these non-derivative financial instruments, other than marketable securities (see note 3), at December 31, 2012 and 2011 does not differ materially from the aggregate carrying value of its financial instruments recorded in the accompanying consolidated balance sheets.

#### **Notes to Consolidated Financial Statements**

Years Ended December 31, 2012 and 2011

#### Note 1 - Summary of Significant Accounting Policies, continued

#### Marketable Securities

The Company classifies investments in marketable securities into one or more of three categories: held to maturity, available for sale or trading based upon the Company's ability, and intent to hold the investment to maturity. Securities classified as trading securities are reported in the financial statements at fair value. Fair value is based on the unadjusted quoted market prices of the securities within an actively traded market. Any unrealized gains or losses are included in the statement of operations and retained earnings. Realized gains and losses, which are determined using the first-in, first-out (FIFO) method, are included in the consolidated statements of operations and retained earnings. Securities classified as held to maturity are reported at amortized cost which approximates fair value.

The Company follows the guidelines established by GAAP regarding fair value measurements and the framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The Company's marketable securities at December 31, 2012 and 2011 consisted of stocks and US Government and corporate obligations, and the investments are valued using level 1 measurements (see Note 3).

#### Materials and Supplies

Materials and supplies are stated at the lower of cost or market. Cost is determined principally by the average cost method.

#### Property, Plant, and Equipment

Property, plant, and equipment in service and under construction are stated at cost, including direct labor, materials, freight, and indirect overhead costs. Maintenance and repairs are charged to operations when incurred. Renewals and betterments are capitalized. Depreciation is calculated on a straight-line basis over the estimated life of the classes of property and equipment in accordance with rates consistent with industry standards.

Depreciation rates range from 2% to 33%. In accordance with composite group depreciation methodology, when a portion of the Company's property, plant, and equipment is retired in the ordinary course of business, the gross book value, plus removal expenses, less salvage, is charged to accumulated depreciation and no gain or loss is recognized in accordance with industry standards.

Non-regulated property and equipment is stated at cost and consists principally of internet and cable television equipment. Depreciation is calculated on a straight-line basis over the estimated useful life of the classes of property and equipment. Asset lives range from 5 to 8 years. Upon disposition of non-regulated assets subject to depreciation, the accounts are relieved of the related costs and accumulated depreciation, and the resulting gain or loss is reflected in operations.

Telecommunication plant acquisition is being amortized over 15 years.

The Company follows the policy of capitalizing interest as a component of the cost of property, plant, and equipment constructed for its own use. In 2012, total interest capitalized to property, plant, and equipment was \$29,593 (\$37,093 in 2011).

#### Accounts Receivable

The Company generally does not require collateral or other security to support accounts receivable. Credit risk associated with receivables is periodically reviewed by management and, if required, an allowance for doubtful accounts is established. An allowance for doubtful accounts of \$90,000 was recorded at December 31, 2012 and 2011. Receivables are considered past due if payments are not received in accordance with invoice terms of net 30 days. Receivables are written off when the Company determines an account is uncollectible.

#### **Notes to Consolidated Financial Statements**

Years Ended December 31, 2012 and 2011

#### Note 1 - Summary of Significant Accounting Policies, continued

#### Investments

Investments in which the Company holds a 20%-50% interest are accounted for on the equity method unless otherwise noted. Investments accounted for on the equity method are recorded at cost and adjusted for the Company's share of income or loss. Investments in which the Company holds less than a 20% interest are recorded at cost.

#### **Network Access Revenues**

Network access revenue related to intralata and interlata toll service is received under a system of access charges. Access charges represent a methodology by which local telephone companies, including the Company, charge the long-distance carrier for access and interconnection to local facilities. The Company has elected to file access tariffs through the National Exchange Carrier Association (NECA), the IPUC, the Nevada PUC, Oregon Exchange Carrier Association (OECA), and the Washington Exchange Carrier Association (WECA). These access tariffs are subject to approval by the various PUC's in the states in which the Company operates for intrastate charges and the FCC for interstate charges.

When network access revenues have been received pursuant to the settlement and access agreements above, they are divided into traffic sensitive, nontraffic sensitive, and billing and collecting portions. The revenues are then either placed into a common pooling arrangement with other exchange carriers for redistribution or kept by the Company. The redistributions are made according to formulas established by the governing boards of the pools and are generally based upon expenses incurred and investments maintained. The Company participates in various pooling arrangements with NECA, WECA, and OECA.

Settlement, access, and pool distribution revenues are recorded when the amounts become determinable. Related expenses are recorded when incurred. Subsequent true-ups and retroactive adjustments, which are generally allowed for a period of 24 months (NECA pool only) after the close of the related calendar year, are recorded in the year in which such adjustments become determinable, based upon studies prepared by outside consultants.

In addition to amounts received from NECA, WECA and OECA, the Company receives revenue from the Universal Service High Cost Loop Fund administered by the Universal Service Administration Company (USAC), and the Oregon Universal Service Fund (OUS) administered by the PUC. The amount of support received from USAC is based on the number of customers served and the cost of providing service in that area being in excess of the national average cost per loop, as determined by the FCC, and are included in network access services revenue in the accompanying consolidated statements of operations.

In 2012, the Company received \$4,753,876 in interstate access revenues administered through the NECA pool (\$4,788,677 in 2011). In 2012, the Company received \$1,510,621 from the USAC High Cost Loop Fund (\$1,664,393 in 2011), and \$128,449 from the OUS fund (\$52,173 in 2011).

#### National Broadband Plan and FCC Order

In 2010 the FCC issued the National Broadband Plan which outlined a long-term plan to increase broadband penetrations and services throughout the United States of America. The plan further outlined a proposed long-term phase-out of access charges (referred to as Intercarrier Compensation) and moved to support mechanisms based on broadband services rather than the current Universal Service High Cost Loop Fund administered by USAC.

In response to the plan, the FCC on October 27, 2011, approved Report and Order 11-161 (the Order), that begins the process of reforming the universal service and intercarrier compensation (ICC) systems and adopts support for broadband-capable networks as an express universal service principle. The Order further creates the Connect America Fund which will ultimately replace all existing high-cost support mechanisms as well as help facilitate ICC reforms.

#### **Notes to Consolidated Financial Statements**

Years Ended December 31, 2012 and 2011

#### Note 1 - Summary of Significant Accounting Policies, continued

#### National Broadband Plan and FCC Order, continued

The Order, among other things, caps the federal universal service fund at current levels and reforms the current system by putting various limits on capital and operating spending, requiring minimum levels for local rates and capping the per-line support amount at \$250 per month. As of December 31, 2012, the Company is not subject to the \$250 per line support cap.

The Order also reforms the ICC system by adopting a plan to transition from access charges to a bill and keep framework. The transition period for rate-of-return carriers such as the Company is 9 years. Recovery will be calculated initially based on the fiscal year 2011 interstate switched access revenue requirement and will decline annually by 5% during the transition period beginning July 1, 2012. The Order includes the adoption of a monthly Access Recovery Charge as a transitional recovery mechanism to mitigate the impact of reduced intercarrier revenues. As of the implementation date, July 1, 2012, the Company is subject to the 5% annual decline in interstate switched access revenue requirement during the 9 year transition period. For the period ended December 31, 2012 the impacts to the Company have not been significant.

The overall reform process takes place in phases and will take several years to implement. Furthermore, the Order includes a Further Notice of Proposed Rulemaking and seeks comments on various items and the ultimate outcome of these proceedings and their impact is uncertain at this time.

#### **Income Taxes**

The Company elected S Corporation status effective January 1, 1999. Earnings and losses after that date will be included in the income tax returns of the stockholders of Martell Enterprises, Inc. Accordingly, no provision has been made for federal and state income taxes in the accompanying financial statements.

#### **Advertising Costs**

Advertising costs are expenses when incurred. Advertising expenses were \$201,820 in 2012 (\$226,964 in 2011).

#### Note 2 - Investments

Investments consist of the following:

	2012	2011
¢	350.070	356,393
Ψ	12,107	12,107
	1,200,965	1,040,581
	30,000	30,000
	433,206	469,094
	18,550	18,391
\$	2,044,898	\$ 1,926,566
	\$ \$ \$	\$ 350,070 \$ 12,107 1,200,965 30,000 433,206 18,550

Investments in other cooperatives are stated at the net realizable value of the patronage and equity allocated to the Company. All other investments are stated at cost, except as noted below.

The Company has a 3.84% interest in Syringa Networks, LLC (Syringa), which provides fiber transport and other services throughout Idaho. The Company accounts for this investment under the equity method even though the ownership interest is less than 20% because management has determined that the Company has the ability to exercise significant influence over operations and financial policies of Syringa.

#### **Notes to Consolidated Financial Statements**

Years Ended December 31, 2012 and 2011

#### Note 2 - Investments, continued

Accordingly, the Company recognizes its proportionate share of the income and losses accruing to it under the terms of its membership agreement. The Company recorded \$218,745 of income from Syringa in 2012 (\$230,737 in 2011).

The following is a summary of condensed financial information pertaining to the investment in Syringa:

	2012		2011
Assets	\$ 71,468,475	\$	36,263,406
Liabilites	39,973,885		14,651,389
Equity	\$ 31,494,590	\$	21,612,017
	Years Ended December 31,		
	2012		2011
Revenues	\$ 45,003,533	\$	33,887,252
Expenses	39,247,225		27,878,466
Net Income	\$ 5,756,308	\$	6,008,786

#### Note 3 - Marketable Securities

The following table is a listing of the Company's marketable securities, which are all Level 1 investments, as of December 31, 2012 and 2011:

	2012	2011
Zynga Inc. Class A Common Stock	\$ 12,119	\$ 47,317
Marketable Securities	22,674	45,897
	\$ 34,793	\$ 93,214

Marketable securities include U.S. Government and corporate obligations with interest rates ranging from 8.95% to 10.375% in 2012 (3.265% in 2011). The bonds totaled \$22,674 at December 31, 2012 and mature in 2015 (\$45,897 at December 31, 2011, maturing in 2012). Management has determined that all bonds held at December 31, 2012 and 2011 are held to maturity and cost approximates fair market value.

Corporate stocks are classified as trading securities and are reported at fair value. The Company recorded unrealized losses of \$35,198 in 2012 (\$2,795 in 2011), which are included in investment income on the consolidated statements of operations.

#### Note 4 - Property, Plant, and Equipment

Listed below are the major classes of property, plant, and equipment in service:

	2012	_	2011
Land and support	\$ 5,586,211	\$	5,498,978
Central office	18,627,679		18,254,517
Cable and wire facilities	27,731,299		26,193,254
Leasehold improvements	204,349		196,639
	\$ 52,149,538	\$	50,143,388

#### **Notes to Consolidated Financial Statements**

Years Ended December 31, 2012 and 2011

## Note 5 - Long-Term Debt

Long-term de	ebt consists	of the	following:
--------------	--------------	--------	------------

Long-term debt consists of the following:				
	_	2012	_	2011
2% notes payable to the Rural Utilities Service (RUS), monthly payments of \$10,896, principal and interest, collateralized by substantially all real and personal property, due in 2017.	\$	196,438	\$	235,600
5% notes payable to the RUS, monthly payments of \$90,700, principal and interest, collateralized by substantially all real and personal property, due in 2029.		7,394,273		8,097,417
2.567% notes payable to RUS for the ARRA Broadband Initiatives Program, monthly payments of \$1,499, principal and interest, collateralized by substantially all real and personal property, due in 2032.		89,719		_
0% notes payable to Toyota Financial Services, monthly principal payments of \$759, collateralized by a vehicle, due in 2013.		1,517		10,861
5.90% notes payable to Wells Fargo Equipment, monthly payments of \$5,476, principal and interest, collateralized by property, due in 2014.		73,909		128,524
4.85% notes payable to US Bank, monthly payments of \$934, principal and interest, collateralized by property, due in 2015.		28,818		39,021
5.0% notes payable to RUS, payable in equal monthly installments of principal and interest, collateralized by substantially all real and personal property, paid in full in 2012.		_		468,300
5.0% notes payable to RUS, interest only payments made monthly through December 2013, then monthly payments of \$10,211, principal and interest, collateralized by substantially all real and personal property, due December 2029.		1,390,360		1,086,045
6.96% to 10.5% notes payable to CoBank, in quarterly installments of \$80,866 principal only, plus interest payable on a monthly basis, and monthly installments of \$43,911, principal only, plus interest, collateralized by substantially all real and personal property, due in 2015.		.,255,550		.,223,010
,		2,216,043		2,575,278
	_	11,391,077	-	12,641,046
Less current portion	_	1,456,624	_	1,768,280
	\$_	9,934,453	\$	10,872,766

#### **Notes to Consolidated Financial Statements**

Years Ended December 31, 2012 and 2011

#### Note 5 - Long-Term Debt, continued

Future maturities of long-term debt are as follows:

2013	\$	1,456,624
2014		1,554,632
2015		1,584,440
2016		641,957
2017		652,773
Thereafter	_	5,500,651
	\$	11,391,077

The long-term debt agreements contain restrictions on the payment of dividends and redemption of common stock and require the maintenance of defined amounts of stockholder's equity and working capital after payment of dividends. The agreements also stipulate certain financial covenants. For the years ended December 31, 2012 and 2011, the Company was not in compliance with the financial covenants of the RUS loan agreement.

At December 31, 2012, POTC had approximately \$11,279,640 of unadvanced loan commitments from RUS.

#### Note 6 - Employee Benefits

The Company participates in a 401(k) savings plan (the Plan). The Plan is available to participants who meet certain eligibility requirements. Eligible participants can contribute a portion of their annual compensation to the Plan subject to Internal Revenue Service limitations. Total employer contributions for 2012 were approximately \$163,200 (\$160,700 in 2011).

#### **Note 7 - Related Party Transactions**

Related party activity consists of the following:

	2012	_	2011
Accounts receivable, stockholders and employees	\$ 153,759	\$	169,442
Accounts receivable, Martell Enterprises, Inc.	72,973		71,529
Accounts receivable, Martell Construction, Inc.	99,916		95,495
Accounts receivable, Little Valley Elk Ranch	125,341		122,861
Notes receivable - shareholders	77,187	_	62,168
	\$ 529,176	\$	521,495

During 2012, the Company leased equipment from Little Valley Elk Ranch, an affiliate company through common ownership, in the amount of \$288,350 (\$478,833 in 2011).

#### **Notes to Consolidated Financial Statements**

Years Ended December 31, 2012 and 2011

#### Note 8 - Broadband Grant and Loan

In 2010, the Company was selected to receive funding for a broadband project by the United States Department of Agriculture through the American Recovery and Reinvestment Act Broadband Initiatives Program. The broadband project is funded through a \$1,770,300 grant and a \$728,700 loan from the Rural Utilities Service (RUS). Amounts requested and received during the year were \$299,063, which included grant funds of \$209,344 and loan funds of \$89,719.

All grant and loan funds must be expended by September 15, 2015. Funding is contingent upon meeting the terms of the grant and loan agreements.

#### Note 9 - Reclassification

Certain accounts in the 2011 consolidated financial statements have been reclassified to conform to the presentation in the 2012 consolidated financial statements. Such reclassifications have no effect on net income.



## **Consolidating Balance Sheets**

December 31, 2012

ASSETS	Rural Telephone Company	Pend Oreille Telephone Company	Nehalem Telecommunications, Inc.	Eliminations	Total
Current Assets:					
	305,622	\$ 508,612	\$ 291,744	- \$	1,105,978
Accounts receivable, net of allowance for	,	,	,		, ,
doubtful accounts of zero	140,926	120,966	68,983	-	330,875
Other accounts receivable, net of allowance	·	·	·		•
for doubtful accounts of \$90,000					
in 2012 and 2011	502,095	164,770	243,065		909,930
Marketable securities	12,119	-	-	-	12,119
Materials and supplies	612,748	230,312	86,186	-	929,246
Prepaid expenses	1,425		21,477		22,902
Total Current Assets	1,574,935	1,024,660	711,455		3,311,050
Other Assets:					
Related party receivables	1,529,244	231,916	57,706	(1,289,690)	529,176
Investments	1,391,919	392,288	260,691	-	2,044,898
Marketable securities	-	22,674	-	-	22,674
Other assets	-	-	13,563	-	13,563
Investment in subsidiaries	4,295,509			(4,295,509)	_
Total Other Assets	7,216,672	646,878	331,960	(5,585,199)	2,610,311
Property, Plant, and Equipment:					
Telecommunications	25,287,208	16,197,416	10,664,914	-	52,149,538
Under construction and held for future use	429,851	381,238			811,089
	25,717,059	16,578,654	10,664,914	-	52,960,627
Less accumulated depreciation	16,430,967	13,697,578	7,655,242	-	37,783,787
Telecommunications, net	9,286,092	2,881,076	3,009,672	-	15,176,840
Non-regulated property, net	33,535	-	-	-	33,535
Acquisition adjustment, net			1,462,218	<u> </u>	1,462,218
Property, Plant, and Equipment, net	9,319,627	2,881,076	4,471,890		16,672,593
;	18,111,234	\$4,552,614_5	\$5,515,305	\$ (5,585,199)	22,593,954

## **Consolidating Balance Sheets, continued**

December 31, 2012

	Rural	Per	d Oreille	e Nehalem			
	Telephone	ne Telephone Telecommu		nuni-			
LIABILITIES AND STOCKHOLDER'S EQUIT	Y Company	Co	mpany	cations,	Inc.	Eliminations	Total
Current Liabilities:							
Current portion of long-term debt	\$ 857,899	\$	-	\$ 598,	725 \$	- \$	1,456,624
Accounts payable	562,745		473,799	197,	666	-	1,234,210
Customer deposits	7,152		4,050		969	-	12,171
Accrued expenses	208,472		125,784	74,	049		408,305
Total Current Liabilities	1,636,268		603,633	871,	409_		3,111,310
Related Party Payables	-		389,587	900,	103	(1,289,690)	-
Long-Term Debt	6,926,775	1,	390,360	1,617,	318		9,934,453
Total Liabilities	6,926,775	1,	779,947	2,517,	<u>421</u>	(1,289,690)	9,934,453
Stockholder's Equity:							
Common stock	56,900	2,	666,346	1,600,	000	(4,266,346)	56,900
Paid-in capital	10,197		-		-	-	10,197
Retained earnings (accumulated deficit)	9,481,094		497,312)	526,	475	(29,163)	9,481,094
Total Stockholder's Equity	9,548,191		169,034	2,126,	475_	(4,295,509)	9,548,191
	\$ 18,111,234	\$ 4	552,614	\$ 5,515,	305 \$	(5,585,199)	22,593,954

## **Consolidating Statements of Operations**

Year Ended December 31, 2012

	Rural	Pend Oreille	Nehalem		
	Telephone	Telephone	Telecommuni-		
	Company	Company	cations, Inc.	<b>Eliminations</b>	Total
Operating Revenues:					
Local network	414,831	\$ 407,265	\$ 515,819	\$ -	\$ 1,337,915
Network access	4,438,799	1,426,806	1,736,961	-	7,602,566
Toll services	-	-	84,610	-	84,610
Internet services	610,358	424,462	671,620	-	1,706,440
Cable television services	130,995	-	-	-	130,995
Miscellaneous	28,774	20,724	156,652		206,150
Total Operating Revenues	5,623,757	2,279,257	3,165,662		11,068,676
Operating Expenses:					
Plant specific	1,509,976	544,987	493,029	-	2,547,992
Plant nonspecific	395,237	178,982	161,109	-	735,328
Customer	252,885	173,112	146,034	-	572,031
Corporate	1,130,618	765,805	593,644	-	2,490,067
Depreciation and amortization	1,324,667	283,108	631,215	-	2,238,990
Cost of toll services	-	-	48,425	-	48,425
Cost of internet services	465,894	350,295	516,604	-	1,332,793
Cost of cable television services	201,181	-	-	-	201,181
Other operating taxes	141,384	36,488	115,481		293,353
Total Operating Expenses	5,421,842	2,332,777	2,705,541		10,460,160
Operating Income	201,915	(53,520)	460,121		608,516
Other Income (Expense):					
Investment income, net	222,115	9,663	26,761	(24,541)	233,998
Other income and expense, net	(32,146)	84,048	(21,102)	-	30,800
Other nonregulated operations, net	163,613	22,537	(71,922)	-	114,228
Income from subsidiaries	188,356	<u> </u>		(188,356)	
Total Other Income (Expense)	541,938	116,248	(66,263)	(212,897)	379,026
Income Available for Fixed Charges	743,853	62,728	393,858	(212,897)	987,542
Fixed Charges - Interest on Long-Term Debt	416,092	76,308	191,922	(24,541)	659,781
Net Income (Loss) \$	327,761	\$ (13,580)	\$ 201,936	\$ (188,356)	\$ 327,761

## **Consolidating Statements of Cash Flows**

Year Ended December 31, 2012

	Rural	Pend Oreille	Nehalem		
	Telephone	Telephone	Telecommuni-		
	Company	Company	cations, Inc.	Eliminations	Total
Cash Flows from Operating Activities:					
Net income (loss) \$	327,761	\$ (13,580)	\$ 201,936	\$ (188,356) \$	327,761
Adjustments to reconcile net income (loss)					
to net cash provided by operating activities:					
Depreciation and amortization	1,324,667	283,108	631,215	-	2,238,990
Unrealized loss on marketable securities	35,198	-	-	-	35,198
Noncash patronage	-	-	(5,400)	-	(5,400)
Income from equity method investments	(218,745)	-	-	-	(218,745)
Income from subsidiaries	(188,356)	-	-	188,356	-
Allowance for funds used during construction	(5,219)	(22,406)	(1,968)	-	(29,593)
Changes in assets and liabilities:					-
Accounts receivable	146,605	13,678	(118,966)	-	41,317
Materials and supplies	(146,546)	(14,442)	28,920	-	(132,068)
Prepaid expenses	3,522	-	(3,414)	-	108
Accounts payable	380,755	358,031	105,523	-	844,309
Customer deposits	(67)	(190)	(540)	-	(797)
Accrued expenses	(33,250)	(9,199)	(50,963)	-	(93,412)
Related party receivables and payables, net	(198,848)	 489,751	(296,466)		(5,563)
Net Cash Provided by Operating Activities	1,427,477	 1,084,751	489,877		3,002,105
Cash Flows from Investing Activities:					
Capital expenditures, net	(849,694)	(557,991)	(176,345)	-	(1,584,030)
Purchase of investments and marketable securities	-	(22,832)	-	-	(22,832)
Proceeds from investments and sales of					
marketable securities	62,920	88,947	-	-	151,867
Change in other assets	-	-	4,349	-	4,349
Proceeds from note receivable		 -	567		567
Net Cash Used by Investing Activities \$	(786,774)	\$ (491,876)	\$ (171,429)	\$ <u> </u>	(1,450,079)

## **Consolidating Statements of Cash Flows**

Year Ended December 31, 2012

		Rural		Pend Oreille	Nehalem				
		Telephone		Telephone	T	elecommuni	-		
		Company		Company		cations, Inc.	Elimination	s	Total
Cash Flows from Financing Activities:									
Payments on long-term debt	\$	(816,449)	\$	(468,345)	\$	(359,235)	\$ -	\$	(1,644,029)
Proceeds from long-term debt		89,700		304,360		-	-		394,060
Proceeds from ARRA BIP grant		209,344		-		-	-		209,344
Distributions to stockholders	_	(90,147)	_	-	-				(90,147)
Net Cash Used by Financing Activities	-	(607,552)	_	(163,985)	-	(359,235)			(1,130,772)
Net Change in Cash and Cash Equivaler	nts	33,151		428,890		(40,787)	-		421,254
Cash and Cash Equivalents, beginning		272,471	_	79,722	-	332,531			684,724
Cash and Cash Equivalents, ending	\$	305,622	\$_	508,612	\$	291,744	\$ <u> </u>	\$	1,105,978
Cash Paid During the Year for Interest, net of amount capitalized	\$	410,873_5	\$_	53,902	\$	191,549	\$ <u> </u>	_\$	656,324

## RURAL TELEPHONE COMPANY

Management Letter and Report on Internal Control Over Financial Reporting and on Compliance and Other Matters

December 31, 2012



Personal Local Global

#### INDEPENDENT AUDITORS' MANAGEMENT LETTER

To the Board of Directors Rural Telephone Company Glenns Ferry, Idaho

We have audited the consolidated financial statements of Rural Telephone Company and Subsidiaries (the Company), for the year ended December 31, 2012, and have issued our report thereon dated 5/8/2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States of America, and 7 CFR 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

In planning and performing our audit of the consolidated financial statements of the Company as of and for the year ended December 31, 2012, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over financial reporting.

A description of the responsibility of management for establishing and maintaining internal control over financial reporting, and the objectives and inherent limitations in such control, is set forth in our independent auditors' report on internal control over financial reporting and on compliance and other matters dated 5/8/2013, and should be read in conjunction with this report.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the Company's financial statements will not be prevented, or detected and corrected on a timely basis. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies in the Company's internal control discussed in the independent auditors' report on internal control over financial reporting and on compliance and other matters to be significant deficiencies.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all such deficiencies have been identified. However, as discussed in our independent auditors' report on internal control over financial reporting and on compliance and other matters, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

7 CFR 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the consolidated financial statements are free from material misstatements, at your request we performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR 1773.33(e)(2), related party transaction, and investments. In addition, our audit of the consolidated financial statements also included the procedures specified in 7 CFR 1773.38-45. Our objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, we express no opinion thereon.

No reports, other than our independent auditors' report on the consolidated financial statements, and our independent auditors' report on internal control over financial reporting and on compliance and other matters, both dated 5/8/2013, or summary of recommendations related to our audit, have been furnished to management.

Our comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters, as required by 7 CFR 1773.33, are presented below.

#### Comments on Certain Specific Aspects of Internal Control Over Financial Reporting

We noted no matters regarding the Company's internal control over financial reporting and its operation that we consider to be material weaknesses, as previously defined, with respect to the:

- Accounting procedures and records;
- Process for accumulating and recording labor, material and overhead costs, and the distribution of these costs to construction, retirement and maintenance, or other expense accounts and;
- Materials control.

## Comments on Compliance with Specific RUS Loan and Security Instrument Provisions

At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures we performed are summarized as follows:

- In performing the procedure with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract, agreement, or lease between the borrower and an affiliate of the Company for the year ended December 31, 2012, we:
  - 1. Obtained and read a borrower-prepared schedule of new written contracts, agreements, or leases entered into during the year between the borrower and an affiliate as defined in 7 CFR 1773.33(e)(2)(i).
  - 2. Reviewed Board of Directors minutes to ascertain whether Board-approved written contracts are included in the borrower-prepared schedule.
  - 3. Noted the existence of written RUS approval of each contract listed by the borrower.
- In performing the procedure with respect to the requirement to submit the Operating Report for Telecommunications Borrowers to the RUS, we:
  - 1. Agreed amounts reported in the Operating Report for Telecommunications Borrowers to the Company's records.

The results of our tests indicate that, with respect to the items tested, the Company complied, in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower has obtained written approval of the RUS to enter into any contract, agreement, or lease with an affiliate as defined in 7 CFR 1773.33(e)(2)(i).
- The borrower has submitted its Operating Report for Telecommunications Borrowers to RUS, and the
  Operating Report for Telecommunications Borrowers, as of December 31, 2012, represented by the
  borrower as having been submitted to RUS, is in agreement with the Company's audited records in all
  material respects.

#### Comments on Other Additional Matters

In connection with our audit of the consolidated financial statements of the Company, nothing came to our attention, except as noted below, that caused us to believe that the Company failed to comply with respect to the following:

- The reconciliation of continuing property records to the controlling general ledger plant accounts addressed at 7 CFR 1773.33(c)(1). The Company is in the process of updating its subsidiary plant records related to outside plant assets to agree with the controlling general ledger plant accounts.
- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR 1773.33(c)(2).
- The retirement of plant addressed at 7 CFR 1773.33(c)(3) and (4). The Company is in the process of updating its subsidiary plant records, which will allow for the timely retirement of plant.
- The approval of the sale, lease, or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap addressed at 7 CFR 1773.33(c)(5).
- The disclosure of material related party transactions, in accordance with FASB ASC 850-10 for the year ended December 31, 2012, in the consolidated financial statements referenced in the first paragraph of this report, addressed at 7 CFR 1773.33(e).
- The detailed schedule of investments.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of investments required by 7 CFR 1773.33(i), and provided below, is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

#### **Detailed Schedule of Investment**

	_	Telephone Company		Telecommuni- cations, Inc.
Original investment Accumulated gains (losses) as of December 31, 2011	\$	2,666,346 (483,732)	\$	1,600,000 324,540
Distributions Undistributed income for 2012		- (13,580)		- 201,936
	<u>-</u>	, , ,	φ	
Book value of investment as of December 31, 2012	\$ _	2,169,034	Ф	2,126,476

Pand Orailla

Mahalam

Pend Oreille Telephone Company and Nehalem Telecommunications, Inc. are wholly owned subsidiaries providing telecommunications services. These investments are accounted for on the equity basis.

This report is intended solely for the information and use of the Board of Directors, management, Rural Utilities Service, and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record, and its distribution is not limited.

 $\mathcal{A}KT\mathcal{L}\mathcal{L}P$ 

Salem, Oregon 5/8/2013



Personal Local Global

## INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Board of Directors Rural Telephone Company Glenns Ferry, Idaho

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the consolidated financial statements of Rural Telephone Company and Subsidiaries (the Company), which comprise the consolidated balance sheets as of December 31, 2012, and the related consolidated statements of operations, comprehensive income, changes in stockholders' equity and cash flows for the year then ended, and the related notes to the consolidated financial statements, and have issued our report thereon dated 5/8/2013.

#### **Internal Control Over Financial Reporting**

In planning and performing our audits, we considered the Company's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Company's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses and therefore, significant deficiencies or material weaknesses my exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses, however, material weaknesses may exist that have not been identified. We did identify a certain deficiency in internal control, described below that we consider to be a significant deficiency.

We consider the following to be a significant deficiency:

#### **Accounting and Financial Reporting**

During the course of the audit, we assisted the accounting staff with reconciling certain activities and proposing adjustments to the general ledger. Our assistance with the reconciliations and adjustments was expected by management and the accounting staff, and all but one of the proposed adjustments was accepted by management and posted to the general ledger. In some cases the adjustments were brought to our attention by the accounting staff, while other adjustments were identified from our audit procedures. In addition, our expertise was required to draft the consolidated financial statements and supporting notes in conformity with accounting principles generally accepted in the United States of America.

Management is responsible for the controls over the selection and application of accounting principles in conformity with generally accepted accounting principles, and is also responsible for the controls over the periodend financial reporting process. The period-end financial reporting process includes the controls over procedures used to initiate, authorize, record and process transactions and journal entries into the general ledger, record recurring and nonrecurring adjustments to the financial statements, and prepare the consolidated financial statements and related notes. Having sufficient expertise in selecting and applying accounting principles is an aspect of such controls.

While the accounting staff of the Company has the ability to perform the daily accounting functions and prepare monthly financial reports for management purposes, they have chosen to rely on the financial statement auditor to prepare the consolidated financial statements and supporting notes. Under current audit standards, the financial statement auditor can not be considered part of the Company's internal control over financial reporting and therefore, our drafting of the consolidated financial statements and notes is considered to be a significant deficiency in the Company's internal control over financial reporting.

Even though management has requested the auditors' assistance in preparing the consolidated financial statements and notes, management is still responsible for the financial information presented. In addition, management is responsible for:

- Making management decisions and performing all management functions.
- Designating an individual with suitable skill, knowledge, or experience to oversee the services provided by the auditors.
- Evaluating the adequacy and results of the services performed by the auditors.
- Accepting responsibility for the results of the services performed by the auditors.

#### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Company's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. Providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. However, we noted one instance of noncompliance which we have reported in our independent auditors' management letter in the Other Matters section, as required by 7 CFR 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. As a result of current year operating results, the Company is not in compliance with the Times Interest Earned Ratio (TIER) requirement as defined and included in the debt agreement with RUS.

#### **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

 $\mathcal{A}KT\mathcal{L}LP$ 

Salem, Oregon 5/8/2013